No. 77-1413

In the Supreme Court of the United States

OCTOBER TERM, 1978

JANE ARONSON, PETITIONER

v.

QUICK POINT PENCIL COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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INTEREST OF THE UNITED STATES

The United States administers and enforces both the federal patent laws and the federal antitrust laws. The patent and antitrust laws seeks to promote economic progress by encouraging the invention, disclosure and commercial development of new products in the competitive marketplace. Under those laws, inventors and their licensees may contract as they choose for the manufacture and sale of new products so long as their agreements do not offend statutory

policies. Because of its interest in the relationship between state trade secret or unfair competition laws and the federal statutes, the United States has participated as *amicus curiae* in the cases that established the major principles that are involved in the present case: *Sears, Roebuck & Co.* v. *Stiffel Co.*, 376 U.S. 225; *Brulotte* v. *Thys Co.*, 379 U.S. 29; *Lear, Inc.* v. *Adkins*, 395 U.S. 653; and *Kewanee Oil Co.* v. *Bicron Corp.*, 416 U.S. 470.

QUESTION PRESENTED

The parties entered into an agreement authorizing respondent to manufacture a keyholder described in a pending patent application. That agreement required respondent to pay either a specified royalty if a patent were granted, or a reduced royalty for an indefinite period of time if a patent were denied. The question presented is whether the federal patent laws or the national policy favoring competition preempts state trade secret law and prevents enforcement of this agreement.

STATEMENT

Petitioner created an original design for a keyholder and applied for a patent (see 35 U.S.C. 101) in October 1955 (Pet. App. A2). Seeking to exploit her discovery commercially, petitioner disclosed it "under conditions of confidence" to several potential licensees (Pet. App. A43, A23). She entered into a licensing agreement with respondent in June 1956

(Pet. App. A30-A32). Respondent obtained the right to manufacture and sell the keyholder disclosed in the patent application; it agreed in return to pay petitioner a royalty of five percent of gross revenues on sales of keyholders that used the design (Pet. App. A30). The license provided that, if no patent should issue within five years, the royalty obligation would be reduced to two and one-half percent, payable as long as respondent used the design (Pet. App. A32).

Respondent made the keyholders and paid the five percent royalty until June 1961, the fifth anniversary of the agreement. It paid the reduced royalty thereafter (Pet. App. A25).

Petitioner's application for a patent was denied on initial consideration in 1956 (Pet. App. A27). An amended application was denied in 1957, and the Board of Patent Appeals affirmed that denial in 1961 (*ibid.*). No patent has issued on petitioner's device.

For many years respondent was the sole manufacturer of keyholders using petitioner's design. It encountered competition in the late 1960s and early 1970s, when at least seven, and perhaps as many as eleven, other companies began manufacturing similar keyholders (Pet. App. A27-A28). These competitors have eroded respondent's share of the market for keyholders using petitioner's design, but respondent's sales have increased (*ibid.*; see also *id.* at A45-A46).

Respondent continued to make the payments called for in the license until September 1975; the total payments were $203,963.84 (Pet. App. A26, A27-

A28). It stopped making payments 14 years after the date that the patent would have issued if the Board of Patent Appeals had ruled in petitioner's favor.[1] It then brought this diversity action, seeking a declaratory judgment that the license agreement is invalid under state law and that, if valid under state law, it is invalid under federal patent and antitrust policies.

The district court entered summary judgment for petitioner (Pet. App. A20). The district court concluded that the license is valid under state law and that the license does not frustrate any federal policy (*id.* at A23).

A divided panel of the court of appeals reversed (Pet. App. A1-A18). Although the court questioned whether the license would be valid under state law as a trade secret license (*id.* at A4 n. 5), it did not resolve this question (*id.* at A9 n. 13). It concluded that federal laws prevent enforcement of the license even on the assumption that it is valid under state law.

The court recognized that federal law does not preempt state trade secret law, but it concluded that state law must give way "at least when a patent application is involved" (Pet. App. A5; emphasis deleted). Under the majority's view, the license involved in this case could have been enforced if petitioner had not applied for a patent; because she did, however,

[1] The life of a patent is 17 years. 35 U.S.C. 154.

the majority reasoned that federal policy requires that her design be available to the public without cost.

Judge Larson dissented. He first found that the license is a trade secret license valid under state law because the design was secret at the time of its disclosure (Pet. App. A9-A11). It made no difference, he argued, that petitioner sought a patent, because this Court recognized in *Kewanee Oil Co.* v. *Bicron Corp.*, 416 U.S. 470, that state trade secret law could apply even when the trade secret was patentable. Enforcing the royalty agreement here would not hamper use of petitioner's design, Judge Larson concluded, because any person may copy and use it without hindrance. Moreover, he reasoned, because no patent had issued, there was no need to allow the licensee to cease paying royalties in order to create an incentive for licensees to challenge invalid patents.

SUMMARY OF ARGUMENT

A. The federal patent and antitrust laws do not preclude the states from enforcing the contractual rights of an inventor unless state law frustrates the achievement of federal policy. The federal patent laws encourage invention, foster full disclosure of useful discoveries, and prevent the removal of commercial ideas from the public domain. Federal competition policy also seeks to foster innovation and to ensure that entrepreneurs may enter new markets with improved products. License provisions of the kind involved in this case promote federal patent and

competition policies by permitting inventors to exploit their inventions commercially even if such inventions turn out to be unpatentable. Because there is no conflict, state law is not preempted.

B. In most cases inventors cannot determine in advance whether their inventions are patentable. Trade secret law allows inventors to obtain compensation for their inventions to the extent that they are actually marketed by manufacturers; it thus protects inventors against the risk of unpatentability, and it provides an increased incentive for innovation. A supplemental incentive to invent does not conflict with, but rather promotes, federal competition and patent policies. *Kewanee Oil Co.* v. *Bicron Corp.*, 416 U.S. 470, 493.

C. A trade secret license providing for royalty payments after denial of a patent application does not conflict with the federal policy encouraging disclosure of new inventions. The incentive to obtain a monopoly under the federal patent laws in exchange for the disclosure of inventions is not disturbed by the availability of trade secret licenses. Trade secret licenses accelerate commercial exploitation and public disclosure by overcoming the incentive to withhold the product embodying the secret pending the outcome of protracted proceedings before the Patent and Trademark Office. *Kewanee Oil Co., supra*, 416 U.S. at 486-491.

D. Enforcement of the trade secret license involved here would not remove commercial ideas from the public domain. A trade secret license does not create or confer the right to exclude competitors,

and so the enforcement of royalty obligations under such an agreement could not prevent competitors from using the trade secret after the licensee discloses it through manufacture. Unlike the situation in *Sears, Roebuck & Co.* v. *Stiffel Co.*, 376 U.S. 225, respondent's competitors may use the invention freely and without cost. The licensee must continue to pay royalties, but only because it chose to obtain a commercial advantage by using the trade secret in advance of its competitors.

Indeed, the court of appeals' holding that states may not apply their trade secret laws to discoveries once the inventor has applied for, but not received, a patent, conflicts with federal policy. The court's rule discourages inventors from seeking patents and disclosing their inventions by imposing a penalty on those who pursue the approved federal route. Inventors could avoid the trap set by the court of appeals only by declining to license their discoveries until after a patent had been issued or denied. "The result would be to hoard rather than disseminate knowledge" (*Kewanee Oil Co., supra*, 416 U.S. at 486).

E. The court of appeals' conclusion that its rule is necessary to implement federal patent laws is incorrect. Neither *Lear, Inc.* v. *Adkins*, 395 U.S. 653, nor *Brulotte* v. *Thys Co.*, 379 U.S. 29, supports the court's decision.

Lear held that a patent licensee may challenge the validity of a patent and, if successful, need not continue to pay royalties. But there was no patent in this case, and therefore there is no need to fashion a

rule that will encourage challenges to questionable patents. Without the issuance of a patent there is no monopoly and nothing for the licensee to challenge: petitioner never acquired a right to exclude competition, and anyone may copy and sell keyholders that use petitioner's design.

In *Brulotte* the Court was concerned that permitting royalties of indefinite duration would enable a patent holder to extend his patent monopoly. But an inventor protected only by trade secret law has no monopoly that can be extended; the value of a trade secret will be determined by competitive forces.

At all events, a rule of law that would induce inventors to demand lump-sum payments, or payments spread over a short period, in order to be assured of adequate compensation for their ideas would not promote competition. It would simply require inventors and their licensees to guess about what the idea would be worth. The guesses might be too low, in which case the incentive to invent would be reduced. The guesses might be too high, in which case the price of the new product would be too high compared to the price of substitutes and competitive forces would induce the parties to reduce the royalties or risk pricing the product out of the market. That would create a systematic bias against adequate compensation for inventors. And even if the guesses often were accurate, the risk of developing and manufacturing an invention would be increased; some developers would be unwilling to take the higher risk, and that would reduce the number of competitors in the business of selling new products.

ARGUMENT

THE ENFORCEMENT OF THE LICENSE AT ISSUE IN THIS CASE DOES NOT FRUSTRATE FEDERAL POLICIES

The agreement between petitioner and respondent is a contract. The enforceability of contracts ordinarily depends entirely on state law. The agreement in this case, for example, would have been a routine patent license if petitioner had obtained a patent. Because no patent issued, the agreement may be understood either as a trade secret license or as a promise by respondent to pay petitioner for services rendered in designing the keyholder. It makes little difference, for present purposes, whether the agreement is a standard trade secret license or a promise of deferred payment for personal services; in either event, the agreement must be presumed to be valid under state law.[2] The only question open here is

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[2] Respondent's complaint asserted that the agreement is invalid under state law. The district court, in entering judgment for petitioner, necessarily found the agreement to be valid. The court of appeals, although questioning the agreement's validity as a trade secret license (Pet. App. A4 n. 5), did not set aside the district court's conclusion (see *id.* at A9 n. 13). The court's decision thus rests entirely on the proposition that federal law prevents enforcement of valid trade secret licenses. In any event, we agree with the position of Judge Larson (*id.* at A9-A11) that the agreement is a valid trade secret license. The design was secret at the time petitioner disclosed it to respondent, and respondent learned the design only by promising to keep it secret until it had agreed to pay for any use it might make of the design. The fact that others might be able to copy the design after use does not over-

whether federal law prevents enforcement of this otherwise-valid agreement. We submit that it does not.

A. A Product License Should Be Enforced Unless Enforcement Would Violate Federal Patent Or Antitrust Policies

The federal patent laws, 35 U.S.C. 101 *et seq.*, encourage invention, foster full disclosure of useful discoveries, and ensure that commercial innovations are available to the public. *Kewanee Oil Co.* v. *Bicron Corp.*, 416 U.S. 470, 480-481, 484. Federal competition policy, as established principally in the Sherman and Clayton Acts, 26 Stat. 209, 38 Stat. 730, as amended, 15 U.S.C. 1 *et seq.*, also seeks to encourage the development of, and competition in, new products. The patent and antitrust laws, taken together, recognize that a limited period of monopoly will both encourage discoveries and enable inventors to coordinate the employment of resources in research and development;[3] but the employment of the patent monopoly depends on true inventiveness, and in the

come the secrecy at the time of disclosure to respondent, any more than "reverse engineering" of any product extinguishes the validity of the initial license. See *Kewanee Oil Co.* v. *Bicron Corp.*, 416 U.S. 470, 474, 476. In this case the design had sufficient commercial value that respondent agreed to pay substantial royalties to have first access to it, and the design was not copied by other firms until more than a decade after its introduction into the market by respondent. (For purposes of convenience we refer to the license in this case as a trade secret license.)

[3] For a concise description of the benefits of the patent and trade secret systems, see Kitch, *The Nature and Function of the Patent System*, 20 J.L. & Econ. 265 (1977). See also Bowman, *Patent and Antitrust Law* (1973).

main "the unrestrained interaction of competitive forces will yield the best allocation of our economic resources, the lowest prices, the highest quality and the greatest material progress." *Northern Pacific Ry.* v. *United States*, 356 U.S. 1, 4.

When state law touches on the area of these federal statutes, "it is 'familiar doctrine' that the federal policy 'may not be set at naught, or its benefits denied' by the state law." *Sears, Roebuck & Co.* v. *Stiffel Co.*, 376 U.S. 225, 229. This Court has confirmed, however, that state trade secret law—aimed at "[t]he maintenance of standards of commercial ethics and the encouragement of invention"—does not conflict with federal patent and competition policies. *Kewanee Oil Co.* v. *Bicron Corp.*, *supra*, 416 U.S. at 481. As we demonstrate below, this Court's conclusions in *Kewanee Oil Co.* apply fully in the present case.

B. Enforcing The License Involved In This Case Would Not Frustrate The Policy Of The Patent Laws To Encourage Invention

Enforcing licenses of the kind involved in this case would not deter innovation or the commercial exploitation of new ideas. To the contrary, enforcement of such agreements would provide greater, not lesser, incentives to inventors and would facilitate commercial development. Inventors often lack the financial resources, manufacturing facilities, and marketing capacity fully to exploit their discoveries. By enforcing the promises of manufacturers to pay royalties,

state trade secret law encourages inventors to disclose their ideas to persons able to share the risks associated with commercial development; trade secret law thus helps new ideas and services enter the marketplace. See *Kewanee Oil Co.* v. *Bicron Corp.*, *supra*, 416 U.S. at 493:

> Trade secret law encourages the development and exploitation of those items of lesser or different invention than might be accorded protection under the patent laws, but which items still have an important part to play in the technological and scientific advancement of the Nation. Trade secret law promotes the sharing of knowledge, and the efficient operation of industry; it permits the individual inventor to reap the rewards of his labor by contracting with a company large enough to develop and exploit it.

Although inventors generally would prefer the greater protection afforded by a patent, *Kewanee Oil Co.* v. *Bicron Corp.*, *supra*, 416 U.S. at 487-488, they cannot always determine in advance whether a discovery is patentable. *Id.* at 487.[4] Trade secret

[4] See Goldstein, *Kewanee Oil Co.* v. *Bicron Corp.*, reprinted in *The Supreme Court and Patents and Monopolies* 279, 290 (Kurland ed. 1975): "During most of the period over which investment is committed to innovation the [inventor] has little idea whether the end product—if there is one—will qualify under the patent laws. * * * Consequently, to eliminate [trade secret protection] would not produce the salutary effect of stimulating investment only in patentable inventions. * * * Rather [it] might instead curtail overall investment in innovation, with resulting losses to both patentable and unpatentable subject matter."

law, which permits inventors to receive compensation even though a patent is ultimately denied,[5] protects them against the risk of unpatentability. It thus increases the incentives for entrepreneurial innovation. "Certainly the patent policy of encouraging invention is not disturbed by the existence of another form of incentive to invention. In this respect the two systems are not and never would be in conflict." *Id.* at 484. See also Bowman, *Patent and Antitrust Law* 38 (1973).

C. Enforcement Of Trade Secret Agreements Will Not Frustrate The Policy Favoring Disclosure Of Inventions

The patent laws require that patent applications provide a sufficiently full description of the invention and "the manner and process of making and using it" so that persons skilled in the art can make and use the invention. 35 U.S.C. 111-112. The patent laws exact disclosure in exchange for the patent monopoly.[6] *Universal Oil Co.* v. *Globe Co.*, 322 U.S. 471, 484. The free flow of both basic and applied scientific knowledge is essential to rapid progress and

[5] State trade secret law properly enforces royalty obligations relating to both patentable and unpatentable inventions. See *Kewanee Oil Co.* v. *Bicron Corp.*, *supra*, 416 U.S. at 485, noting that "[t]rade secret law will encourage invention in areas where patent law does not reach."

[6] Disclosure is important because it enables other persons to build on the base established by the first inventor. Disclosure also facilitates the coordination of investment in research and development. See Kitch, *supra*, 20 J.L. & Econ. at 267-271, 276-278.

maximum use of scientific resources. *Graham* v. *John Deere Co.*, 383 U.S. 1, 9. If the enforceability of trade secret agreements served to divert inventions from the patent system, thereby diminishing public disclosure, there would be a strong argument for setting the state law aside.

Enforcement of alternative patent-trade secret licenses such as the agreement involved here would not, however, diminish disclosure by diverting inventions from the patent system. Such agreements generally encourage inventors to seek federal patent protection without compromising their ability to participate in the commercial value of their inventions if patent protection is denied. If the patent application should be granted, the patent system would provide for disclosure. The agreement here in question contemplated an application for a patent, and it provided for double royalties in the event that petitioner obtained a patent. The double royalty provision in the trade secret license gave petitioner every incentive to prosecute the patent application vigorously, and the denial of the application was not caused by the trade secret license. Moreover, federal law itself provides for the nondisclosure of applications that do not ripen into patents (35 U.S.C. 122), so that any nondisclosure in the present instance could not violate federal principles.

In our view, the decision of the court of appeals poses a much greater threat to full disclosure than does the application of state trade secret law. Under the principles of *Kewanee*, states may apply their

trade secret laws whether or not the discovery is patentable. The court of appeals put a gloss on *Kewanee* by holding that state trade secret law is preempted "at least when a patent application is involved" (Pet. App. A5; emphasis deleted). If the inventor seeks patent protection for a discovery that turns out to be unpatentable, he not only does not obtain a patent monopoly but also loses the protection of state trade secret law. But, as the Court recognized in *Kewanee*, in many if not most cases the inventor cannot know in advance whether a patent will be issued (416 U.S. at 487). The court of appeals' gloss on *Kewanee* means that in cases in which patentability is doubtful, the inventor has a reduced incentive to apply for a patent.

If inventors and discoverers should apply for patents less frequently, there would be fewer disclosures in connection with the patent system. Alternatively, the court of appeals' rule might induce applicants for patents not to license their inventions until the patent had been either issued or denied. "The result would be to hoard rather than disseminate knowledge" and to retard the employment of useful discoveries. *Kewanee Oil Co.*, *supra*, 416 U.S. at 486. The court of appeals' holding—which deprives petitioner of royalties *because* she applied for a patent—creates a disincentive to use the patent system and thus frustrates federal policy.

D. Trade Secret Royalty Agreements Do Not Remove Unpatentable Ideas From The Public Domain

Relying principally on *Sears, Roebuck & Co.* v. *Stiffel Co.*, 376 U.S. 225, and *Compco Corp.* v. *Day-Brite Lighting, Inc.*, 376 U.S. 234, the court of appeals concluded that the trade secret agreement involved here is invalid because "federal law requires that all ideas in general circulation be dedicated to the common good unless they are protected by a valid patent" (Pet. App. A4). That general principle is unexceptionable, but it does not support the result reached by the court of appeals.

Sears and *Compco* held that state unfair competition laws may not prevent competitors from copying unpatented designs. The Court pointed out in *Sears* (376 U.S. at 229) that the right "to exclude others from the use of invention" is the essence of the patent monopoly. If federal law withholds that "right to exclude," a state may not confer the right. This principle, however, has nothing to do with the question whether express contractual royalty obligations should be enforced. Nothing in the payment of a royalty excludes any person from making a keyholder, and the license does not keep any idea out of the public domain.

The keyholder designed by petitioner was not in the public domain at the time the license agreement was concluded. Petitioner communicated her novel design "in confidence" (Pet. App. A43) to respondent and several other potential manufacturers. This confidential communication was entirely consistent with

federal policy, which does not require that all ideas be placed in general circulation. *Painton & Co.* v. *Bourns, Inc.*, 442 F.2d 216, 225 (C.A. 2). The federal policy "that matter[s] once in the public domain must remain in the public domain is not incompatible with the existence of trade secret protection. By definition a trade secret has not been placed in the public domain." *Kewanee Oil Co.* v. *Bicron Corp.*, *supra*, 416 U.S. at 484.

Products embodying trade secrets can be copied after their initial sale; if the secret is not evident on inspection of the product, "reverse engineering" may enable a competitor to learn the secret. Many of respondent's competitors copied and sold products using petitioner's design. No state law interfered with the copying and sale; that is why this case does not present the bar to competition that was present in *Sears* and *Compco*. Petitioner's design is now "in the public domain and can be copied in every detail by whoever pleases." *Compco Corp.*, *supra*, 376 U.S. at 238. The license requires respondent to continue to pay royalties, but that is the consequence of the bargain that it negotiated in order to market the product ahead of its competitors.

E. Enforcement Of Alternative Patent-Trade Secret Licenses Of The Type Involved In This Case Will Promote Competition

National competition policy seeks to promote a predominantly free market economy in which entrepreneurs enter into commercial agreements based on

their private judgments about how to advance their economic welfare. Only where those agreements unreasonably restrain trade or lessen competition does federal competition policy invalidate the private transaction. *Continental T. V., Inc.* v. *GTE Sylvania Inc.*, 433 U.S. 36, 49-50.

The parties in this case negotiated an agreement that permitted both of them to profit from their contributions to keyholder sales. The agreement appears to have been voluntary on both sides. If the keyholder succeeded commercially, both parties reaped profits; if it failed, the manufacturer had no royalty obligations and the designer received no reward for a worthless idea. Analysis of the competitive effects of such an agreement shows that it promotes rather than retards competition.

1. State law allows inventors to secure compensation for their discoveries through trade secret licenses, thereby providing additional incentives for commercial innovation. Petitioner's agreement with respondent induced her to disclose her design to a capable manufacturer, which produced keyholders based on the design and marketed them to the public. As this new market emerged, seven or more other companies copied the design and became respondent's rivals. As a result, a competitive market exists today based on the design and disclosure fostered by the trade secret agreement. Here, as in *Kewanee Oil Co.*, *supra*, 416 U.S. at 485, state law assures that "[c]ompetition is fostered and the public is not deprived of the use of valuable, if not quite patentable, inven-

tion." Invalidation of the agreement would inhibit disclosure by other inventors, who would be reluctant to impart their knowledge to manufacturers who might repudiate their obligations.

2. The court of appeals believed that *Lear, Inc.* v. *Adkins*, 395 U.S. 653, and *Brulotte* v. *Thys Co.*, 379 U.S. 29, require the preemption of state trade secret law to the extent that law would apply to discoveries for which a patent has been sought and denied. *Brulotte* held that patent licensees may not be required to pay royalties after the patent has expired; *Lear* held that patent licensees may challenge the validity of any patent that issues and, if successful in that challenge, may cease paying the royalties required by contract. The court of appeals pointed out that, if petitioner's patent application had been granted, she would not have been able to collect royalties after its expiration or after a declaration of its invalidity, and it concluded that petitioner should not be better off simply because her patent application was denied.

It is hard to understand how enforcement of the license between petitioner and respondent would make petitioner "better off" because her patent application was denied. The denial of the application cut in half the royalty payments respondent was obligated to make. Moreover, petitioner lost any ability to exclude respondent's competitors from using her design; the competitors were free to, and did, copy the design without paying royalties. The denial of patent pro-

tection thus cost petitioner substantial sums that she otherwise would have received.

The more telling point, however, is that the principles underlying *Lear* and *Brulotte* do not apply when no patent has issued. *Kewanee* establishes this as a general matter, for many of the reasons we already have discussed.

In *Lear* the Court was concerned that forbidding patent licensees to challenge the validity of a patent[7] would remove from the class of potential challengers the persons with the greatest incentive to test the patent's validity and the greatest knowledge about the circumstances showing invalidity. The Court stated that it is important to subject patents to judicial scrutiny because they have been issued after *ex parte* proceedings, and judicial review may cast their validity in a different light. Moreover, because patents create a right to exclude competition—a lawful monopoly—there is an important public interest in ensuring that this monopoly is conferred only when the statutory criteria have been satisfied.

Trade secret licenses, however, do not stultify challenges to the validity of patents. By definition there is no patent to be challenged. There is no grant of a lawful monopoly and no need to ascertain whether the proper statutory criteria have been applied. Because petitioner never acquired a right to exclude competition in the use of her design, no federal purpose would be served by excusing respondent from its contractual obligation to pay royalties.[8]

[7] Or, what is the same thing, allowing a challenge but requiring the licensees to pay the agreed royalties even if the challenge is successful.

In *Brulotte* the Court was concerned that permitting royalties of indefinite duration would enable a licensor to extend his patent monopoly beyond the statutory period. It should be plain, however, that an inventor protected only by trade secret law has no monopoly that can be "extended." Petitioner never had a legal monopoly of any sort; she had only the worth of her design in a competitive market, and there is no reason why she and a willing licensee cannot agree to spread the payments for that design over its full useful life.[9]

As we have discussed above (pages 12-13, *supra*), the value of a discovery often cannot be determined

[8] We believe, however, that the rationale of *Lear* would invalidate any license that called for the payment of reduced royalties if a patent were issued and then held invalid. First, an idea becomes public knowledge when a patent issues, and this public idea could not thereafter be the subject of trade secret protection. Second, a licensee needs the maximum possible incentive to challenge arguably invalid patents. Allowing the licensor to collect some reduced royalty (perhaps a substantial portion of the full royalty) after a declaration of patent invalidity would undermine this incentive. There would be no principled ground on which a court could uphold a contract calling for 25 percent of the original royalty after a declaration of patent invalidity while forbidding a contract calling for the payment of 99 percent of the original royalty, and it is therefore appropriate to conclude that no royalty may be collected after a patent has been declared invalid.

[9] The agreement was similar to the trade secret license upheld in *Warner-Lambert Pharmaceutical Co.* v. *John J. Reynolds, Inc.*, 178 F. Supp. 655, 663 (S.D. N.Y.), affirmed,

prior to its commercial exploitation. If federal law were to induce inventors to collect all of their royalties during the first few years of the discovery's employment—before final action on a patent application or perhaps, as the court of appeals hinted, even before the first public disclosure of a trade secret (Pet. App. A4 n. 5)—the parties would be forced to speculate about the worth of the idea in order to determine the appropriate payment. Setting a lump-sum payment, or compensation to be measured and paid over a short span, is difficult to do.[10] If the estimate of market value should turn out to be too low, the licensee would get off cheaply and the inventor would not receive the full value of his contribution; that would reduce the incentive to invest in research, invention and design. If the esti-

280 F.2d 197 (C.A. 2). There, the manufacturing licensee sought to relieve itself of its obligation to pay royalties on sales of Listerine mouthwash. The ingredients of the mouthwash had been known in the trade for some 25 years before the licensee sued; nevertheless, the court held:

> There is nothing unreasonable or irrational about imposing [a perpetual royalty] obligation. It is entirely rational and sensible that the obligation to make payments should be based upon the business which flows from the formula conveyed. Whether or not the obligation continues is in the control of the plaintiff itself. For the plaintiff has the right to terminate its obligation to pay whenever in good faith it desires to cease the manufacture or sale of Listerine.

[10] *Ex ante* estimates of commercial value must take into account the likelihood of a patent issuing, the public demand for the product, the prospect of utilizing the invention in new applications, the costs of commercial exploitation, and the

mate of market worth should turn out to be too high, the licensee would have costs that are too high for the market. That might produce a windfall for the inventor if there had been a lump-sum payment; but more likely, if the royalty initially were set too high, and if that made the selling price too high to compete effectively with substitutes, thus preventing effective exploitation of the discovery, then the parties would agree to reduce the payments. In other words, the royalty would not exceed the amount set by competition in the marketplace. But no similar market discipline would lead to an increase in royalties that initially were set too low. There is therefore a systematic bias against inventors under a rule of law effectively requiring payments in a lump sum or over a short period. That bias would reduce the incentive to invent.

Even if, over the long run, payments to inventors as a group approximate market value, with some predictions too high and some too low, the problem of disparity between the projections and reality increases the risk to licensees in exploiting inventions.[11]

probability of competitive entry. Inventors and licensees naturally would hesitate to make a final determination of the commercial value of an invention and the amount of consideration to be paid on the basis of these projections. See Posner, *Economic Analysis of Law* § 4.1 (2d ed. 1977): "The danger that the exchange may not really be value-maximizing is much greater when * * * the costs and benefits involved in the exchange may not become known to one party until he has already completed his agreed-upon performance."

[11] An increase in the risk borne by the licensee also would require the licensee to seek a higher rate of return on the

An increase in risk may make smaller firms unwilling to accept licenses, because they cannot spread the risk over many discoveries and products. To the extent that the court of appeals' decision would reduce the number of firms willing to bid for trade secrets, it would tend both to decrease the reward for inventions and to make it more difficult for smaller firms to develop new products, tendencies that would run counter to federal patent and competition policies.

3. Requiring licensees who have agreed to pay royalties for indeterminate periods to comply with their agreements should not impose significant disadvantages on them relative to their competitors. Trade secret licensees bargain for a head start, and they obtain the advantage over their competitors of early development of customer relationships, brand identification, and an initial period of sales without competition. Whether such licensees are wise to promise long-term payments is not a matter of governmental concern. The law does not preclude licensees from paying a flat fee at the beginning of the license period, and there is no reason to prohibit the alternative of distributing payments over the use-

funds it has invested in development of inventions. Because the licensee will face competition from producers of substitutes for the discovery or design, it cannot charge a price higher than the price it would have charged if the risk had been smaller. The licensee thus can receive compensation for its increased risk only by reducing the average amount paid to inventors for ideas. A reduction in the average payment for ideas, over the long run, would diminish the supply of new ideas.

ful life of the invention if the parties find that preferable.

The market most likely will dictate the form of royalty agreements. It would be contrary to the self-interest of inventors and designers for them to demand royalties that do not approximate the value of their inventions. Royalties that are too high, or would continue for too long, would place licensees at an untenable disadvantage relative to rivals who exploit the idea free of charge. After all, the compensation of licensors depends on the volume of sales by licensees, and that volume cannot be sustained if licenses subject sellers to excessive costs, which would make sales unprofitable. Licensors seeking to maximize their income may well reduce their royalty demands, thereby allowing licensees to make a profit at the market price (or to reduce their price and meet competition). Licenses always can be revised to reflect changes in market conditions, and the parties to a trade secret license have every incentive to cooperate to increase their joint welfare. The rational licensor would not act contrary to its own economic interests by insisting on payment for an idea that had lost its commercial value, and if the licensor acted irrationally the licensee could protect itself by ceasing to use the trade secret.[12]

[12] The fact that respondent has increased its sales of the keyholder, even while paying royalties that its competitors do not pay, suggests that petitioner's design has a continuing value. Perhaps respondent's competitors have not copied the design exactly, so that the information petitioner disclosed

Conversely, there appears to be no serious risk that imparting trade secrets to a single manufacturer for an indefinite period under a licensing agreement will confer undue competitive advantages. The 17-year period of protection afforded under the federal patent laws is a monopoly grant designed to stimulate invention. State enforcement of trade secret contracts, on the other hand, does not usually confer substantial or enduring market power. The degree of market power conferred by a trade secret is immediately limited by the ability of competitors to produce substitute or identical products by independent discovery or reverse engineering. Market power conferred by a trade secret is subject to rapid dissipation if another party discovers the trade secret. As this Court noted in *Kewanee Oil Co.* v. *Bicron Corp.*, *supra*, 416 U.S. at 490, "[i]f something is to be discovered at all very likely it will be discovered by more than one

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to respondent still gives respondent a competitive advantage. Or perhaps respondent's competitors have been required to hire designers and draftsmen to duplicate the design. Duplicating the design would have imposed costs on respondent's competitors, and the competitors must recover those costs of doing business. The royalties respondent pays to petitioner may be approximately equal to the costs the competitors encountered in duplicating the design.

Our point here is that the cost of acquiring information is a cost of doing business. Respondent bought information from petitioner, while respondent's competitors acquired their information in some other way. There is no reason rooted in federal law why respondent, but not its competitors, should be relieved of the cost of information acquisition. See *Kewanee Oil Co.*, *supra*, 416 U.S. at 482.

person." Unlike the situation where a patent has been conferred, moreover, third parties are free to copy the invented product, and competition to copy the product will be intense if it has commercial value. In many cases the mere manufacture and sale of a product results in disclosure of the trade secret, and market power declines rapidly. That appears to be the case here. Thus, as a general rule,[13] the Court need not be concerned that enforcing royalty obligations for indeterminate periods will undermine federal antitrust policies.[14]

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[13] We do not suggest that long-term trade secret licenses never raise competitive problems. If entry barriers exist and the trade secret has not been discovered after a significant period of time, or if the trade secret license appears otherwise to have impaired effective competition, such licenses may become unreasonable restraints of trade. The option of enforcing the antitrust laws against such restraints may be preserved, however, without establishing a *per se* rule that deprives parties of the right to enter into alternative patent-trade secret licenses that in most cases do not violate public policy. See *Continental T. V., Inc.* v. *GTE Sylvania Inc.*, *supra*, 433 U.S. at 49-50.

[14] Pleas by contracting parties to escape the obligation of their agreements on the theory that such agreements offend competitive policies have "not met with much favor in this Court." *Kelly* v. *Kosuga*, 358 U.S. 516, 518. As the Court pointed out in *Kelly:* "Obviously, state law governs in general the rights and duties of sellers and purchasers of goods, and, while the effect of illegality under a federal statute is a matter of federal law * * * even in diversity actions in federal courts * * * the federal courts should not be quick to create a policy of nonenforcement of contracts beyond that which is clearly the requirement of the Sherman Act" (*id.* at 519).

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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